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THE ASSESSMENT: ECONOMICS OF TRANSITION IN EASTERN AND CENTRAL EUROPE

CHRISTOPHER ALLSOPP
New College, Oxford
HENRYK KIERZKOWSKI
Graduate Institute of International Studies, Geneva[1]

This Assessment provides an overview of the stylized facts and the underlying economic issues involved in transition, with a focus on the more successful reforming countries. Microeconomic, macroeconomic, and institutional factors interact. Particular emphasis is given to the initial output falls at the start of reform, where it is suggested that a generalized price-raising response by state enterprises to monetary tightness, liberalization, and devaluation was one of the main culprits. Trade liberalization has proved to be an extremely important and successful aspect of the strategies followed, but there are increasing dilemmas over exchange-rate policy at both the micro- and macroeconomic levels. A partial solution is further progress with institutional and, especially, banking-sector reform, but the policy conflicts will remain in an increasingly open and integrated international environment.

I. INTRODUCTION

Five years ago, two complete issues of the *Oxford Review of Economic Policy* were devoted to the economics of transition in Eastern Europe—one on micro- and one on macroeconomics. At that time, the subject was relatively new and information limited: even Poland, the first country to initiate a 'big-bang' strategy of economic and political change, was barely 2 years into the programme. Czechoslovakia (now the Czech and Slovak Republics) and Hungary only really started the process of transition in 1991.[2] And at that time, no previously centrally planned country in eastern Europe had established the process of recovery and growth.

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[2] Hungary had, of course, been introducing gradualist reforms for some years previously.

Table 1
GDP Levels in Selected Transition Economies
(1989 = 100)

	Eastern Europe			Former Soviet Union	
	1991	1996		1991	1996
Czech Republic	80	89	Russia	71	51
Hungary	82	86	Belarus	87	63
Poland	84	104	Ukraine	79	42
Slovakia	79	90			
			Estonia	73	69
Bulgaria	74	68	Latvia	61	52
Romania	75	88	Lithuania	51	42

Source: EBRD (1997).

Now, in 1997, there is vastly more information available on many more transition economies and on their often divergent developments since the early 1990s. Diversity of experience presents, of course, difficulties for any overview or assessment. Fortunately some 'stylized facts' are beginning to emerge.

First, the initial effects of transformation in all the countries we are concerned with, have involved substantial falls in output. These also occurred in the first 2 years in the former German Democratic Republic. Transition, it appears, involves large initial costs. This, however, is in stark contrast to the experience of China, and now Vietnam, where more gradualist reforms have been combined with continuing rapid growth (World Bank, 1996).

Second, the pattern of initial falls in output does not correlate with the need for initial macroeconomic stabilization—it was as large in Hungary and the Czech Republic (which had only moderate initial inflation) as in Poland, which had hyperinflation in 1989. Russia had very high inflation after liberalization—and so on. On the other hand, macroeconomic stabilization and control do appear important for sustainable recovery.

Third, the similarity of initial response has given way to wide diversity with, broadly, a pattern of recovery being seen in eastern Europe[3] (with Poland out in front with a return to 1989 levels of GDP around 1996), but continuing declines in Russia and most other countries in the Commonwealth of Independent States (Table 1).

Fourth, recovery is associated with indicators of progress in reform—both micro and macro—as, for example measured by various indicators compiled by the European Bank for Reconstruction and Development (EBRD). In practice, this association is also geographical. Reform and recovery have, by and large, gone furthest in central Europe and the Baltics, with continuing problems (e.g. of macro stabilization) and continuing falls in GDP, further east and further south. The recent macroeconomic instability in Bulgaria or the spectacular political and economic collapse in Albania are ample reminders that transition, even if it seems on course, can easily get derailed.

Fifth, different aspects of transition and reform proceed at different rates. There is a very wide divergence of experience, reflecting, *inter alia*, differences in the political situation, in starting points and in the shocks experienced along the way. But some of the divergence is intrinsic. Some things—macroeconomic restraint, price liberalization, trade liberalization—can, in principle, be done quickly. Other things, such as privatization, changes in corporate governance, and financial-sector reform in-

[3] For brevity we use the term eastern Europe to refer to those countries in central and eastern Europe which were not part of the former Soviet Union. It corresponds to the World Bank (1996) concept of central and eastern Europe (CEE). We refer to the smaller group of countries, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia, as central eastern Europe, or just central Europe.

Table 2
GDP Per Capita in Selected Western and Eastern European Countries, 1995 (in US$)

	At market exchange rates	At purchasing power parities
Austria	26,890	21,250
Spain	13,580	14,520
Portugal	9,740	12,670
Greece	8,210	11,710
Czech Republic	3,870	9,770
Hungary	4,120	6,410
Poland	2,790	5,400
Bulgaria	1,330	4,480
Russia	2,240	4,480
Estonia	2,860	4,220

Source: World Bank (1997).

evitably take much longer. In crude terms, 'big-bang' strategies can be seen as doing all the things that can be done quickly up front: gradualist strategies, apart from being slower, often involve a different sequencing (e.g. giving greater priority to financial reform before other things are attempted) (Rybczynski, 1991).

These features suggest a simple categorization of the stages of transition (the stages are marked in economic time, not calendar time). The initial stage (Stage I), frequently involves macroeconomic stabilization, but also substantive systemic change to start the process of transition to a market-oriented economy. Stage II might be thought of variously as consolidation, or of managing the transition, with an accent on building the foundations of a market economy through institutional and legal reforms (clearly, Stages I and II merge together in gradualist as opposed to 'big-bang' strategies). Stage III is in the future: the process of growth and development, or, it is hoped, 'catch-up'.

Stage I is, from an analytical point of view, relatively simple. Anyone can recognize serious macroeconomic disequilibrium (inflation at, say, 500 per cent, or shortages and a monetary overhang, or a budget deficit totally out of control) and recommend restraint. Similarly, anyone can recognize a massively distorted economy and propose saner prices or liberalization. The difficulty is in how to achieve the restraint and liberalization and to deal with the side effects (e.g. dislocation, interest group pressures, or political backlash). Stage II is the main focus of this Assessment. How has reform progressed? What are the interactions between macro- and micro-economic developments? How should corporations or banks be restructured? If the issues in Stage I are broad-brush, Stage II involves the hard detail. Structural changes take time and institutions need to be designed. Not surprisingly, as many have noted (see Ellman, this *Review*) continuing reform needs a competent administration and strong government.

With regard to development and 'catch-up', few specific judgements can be made at this stage. World Bank estimates of 1995 GDP per capita levels (at purchasing power parities) show that in Hungary and Poland these were at no more than 50 per cent of the equivalent levels in the two poorest western European countries—Greece and Portugal (Table 2). Clearly, there is plenty of catching up to do and, were it to occur, it would justify the considerable costs of transition. But are eastern European countries in any more favourable a position for converging on western European living standards than other low- or middle-income countries? One argument is that the removal of the repressive constraints of the previous planning system would lead automatically to output rises and 'catch-up', an argument supported by the observation that human capital in the form of education and skills is relatively high.

Interestingly, in their article in this *Review*, Brenton and Gros put forward the challenging statement that, from the point of view of international trade, there is little difference between the more successful transition economies and the lower-income western European countries. In other words, if one did not know that the central European countries were transition economies, one would not be able to deduce that history from their present trade data. The question is more general. For those countries that have succeeded in the initial stages of transition, does the label 'transition economies' still have meaning?

The emphasis of this Assessment is on the relatively successful eastern European countries. This is partly because experience is so diverse and a focus is necessary. But it is also because there is an obvious interest in lessons and contrasts. If there are lessons, then there is a view that they are more likely to be found among the relatively successful.

The next section considers, from an economic point of view, some basics about 'transition' which sometimes get submerged in the detail. Section III looks selectively at aspects of experience—the output declines at the beginning of transition, the external dimension, macroeconomic control, and institutional change. Section IV concludes.

II. TRANSITION BASICS

(i) Microeconomic Change

Markets versus planning

To judge by the political debates, many commentators on 'transition' would be surprised by the fact that standard economic theory does not claim that markets are necessarily better than planners. Instead, the first fundamental theorem of welfare economics—the tidied up version of Adam Smith's principle of the invisible hand—states that, under certain conditions, a decentralized, competitive market can deliver an efficient allocation of resources. So, too, in pure theory, can a perfect planning system, as was shown in the once popular Lange–Lerner analysis (see, for example, Lange, 1938). Indeed, it is a standard device to compare the results of a decentralized allocation with the (notional) choices that would be made by an ideal social planner. At this level of abstraction, markets and planning are alternative ways of organizing an efficient allocation of resources.[4]

Thus, any claim that a market system is 'better' than a planning system depends upon additional assumptions and arguments (which, while very plausible in practice, are often informal). Putting aside, for the moment, questions of income distribution, a useful first approach is to consider the departures of both systems from the notional ideal in terms of 'planning failures' versus 'market failures' (Helm, 1986). In the present context, it is hardly necessary to go into detail about possible planning failures, except to note that the term covers several different things, ranging through the political (e.g. lack of freedom or democracy), through questions of income distribution (e.g., in the extreme, the system might be efficiently dedicated to the aggrandizement of a dictator), to questions of economic efficiency. It is the latter we are most concerned with here. At a theoretical level, the principal claim is that a centralized planning system will be inefficient, owing, for example, to the complexity of the task and the impossibility of the information requirements. This latter leads on to claims in favour of decentralized market systems.[5]

But decentralized market systems are not perfect either. For example, the replacement of a state-run utility industry by a private monopoly would hardly be wise—hence the concern in such sectors over privatization *plus* regulation. More generally, the efficiency properties of decentralized markets crucially depend not only on competition but also on well-functioning institutions, such as an efficient banking system, neither of which is typically present at the start of transition. Other problems, such as environmental

[4] The concept of efficiency is Pareto optimality, which is silent on income distribution. *Prima facie*, planners have the advantage in that they can take distributional issues into account, an advantage which is only partly redressed by the second fundamental theorem of welfare economics.

[5] Advocates of transition from planning to the market have, of course, many agendas, including political and distributional considerations. Arguably, however, it was the widespread conviction that the planning system was failing on efficiency grounds that was most important.

externalities, are as much an issue for a market system as for the previous planning regime.[6]

The above is couched largely in terms of the standard static resource allocation framework of neoclassical economics. There has always been another strand to the debate which has been much more critical of planning. Those in the 'Austrian' tradition—especially the Hayekian 'new right'—have stressed the importance of decentralized markets based on private property in fostering innovation and growth and in dealing flexibly with change and uncertainty.[7]

The static and dynamic traditions, in effect, come together in modern industrial economics with its emphasis on strategic interaction, information asymmetries, incentive structures, and the dynamics of innovation. Contrary to the 'new right' position, however, this does not usually lead to the prescription of complete *laissez-faire*: potential market failures are pervasive. In practice, as the articles in this *Review* illustrate, this also means an emphasis on institutional issues such as corporate governance (see Carlin and Landesmann) or the structure of the banking system (Steinherr). In the same spirit, models are being developed of the *process* of transition—e.g. of the incentives and mechanisms by which a system based largely on state firms is transformed into one based on private firms (see, for example, Blanchard, 1997).

What is transition?

If the planning system is highly inefficient, and the market system is taken to be efficient, this gives a clear meaning to the idea of 'transition'—the rapid, or gradual, move from a position well inside the 'production possibility frontier' to a more efficient position close(r) to the frontier. It is notable, however, that there are two things going on, not one. The first is a major change in the coordination and allocative system. The second is a change in efficiency. Moreover, the change in allocative system is regarded as *instrumental* in the achievement of the efficiency gains.

Less formally, and given the largely unsuccessful attempts to reform the planning system in the 1980s, the idea of 'transition' came to mean the wholesale replacement of the previous centralized model with a political and economic blueprint taken to be characteristic of successful market economies. As a guide to action, the objective of introducing a known model—despite the ambiguities and dangers—has obvious advantages as compared with trying to design a more efficient system from scratch.[8]

An objective of becoming 'like' a developed market economy has the advantage of being both clear enough to provide a guide to action along the way and vague as to details. In broad terms it suggests the importation and adaptation of 'institutions' (such as banks, regulatory procedures, corporate law) and the development of property rights and markets, but with a good deal of scope for national variation. For many eastern European countries (especially the Visegrad four) association agreements with the European Union (EU) and the aim of entry further tighten up the objective and strengthen the imitative aspects of the reform or transition strategy. The goal of EU membership may well be more important than entry itself.

It is clear that there is nothing special about the desired end-point of transition to distinguish these economies from many other low- or middle-income countries aiming for accelerated development of a market-oriented kind. To the extent that they are special enough to be singled out as a separate category, it is because of their starting point as centrally planned economies. Thus, transition needs to involve the dismantling of one (politically discredited) system and its replacement by another. Since the political, legal, and institutional changes required to go with this are large, and so is the potential for disruption, this may be regarded as a disadvantage. But these economies also started with considerable advantages. Notably, especially in central Europe, human capital was relatively high. So was social provision (though this can also be a disadvantage, especially for macroeconomic control). Above all,

[6] Inherited environmental problems are an obvious feature of post-communist economies (Hughes, 1991). Some of these are due to previous mis-pricing, such as in the energy industries. Dealing with negative externalities, however, involves intervention of one kind or another to improve on the market allocation.

[7] Schumpeter was prepared not just to tolerate but sometimes to advocate monopoly on the grounds that it promoted investment and innovation. Modern industrial economics stresses potential conflicts between static and dynamic efficiency.

[8] Ellman (this *Review*) suggests that 'holistic social engineering' proved to be possible largely because of the imitative principle.

individual property rights were relatively evenly distributed, with most assets vested in the state. Arguably, such a situation, where entitlements remain to be established, is much more favourable than one in which most assets are concentrated in a few powerful hands.

Policies for microeconomic transition

In practice, transition has proved to be much more complex (and costly) than a simple process of tearing down the old planning system combined with the promotion of private property and markets. Part of this is due to the initial need for macroeconomic stabilization (and the interaction between microeconomic and macroeconomic factors). We come to this below. It is also due to the need for different *kinds* of strategy for different aspects of transition, which need to be unpicked. Generally, there is a paradox about transition: though the desired end-point may be a market system with light government, arguably, transition itself needs *more* policy not less. Transition needs to be planned and the institutions that support a market system need to be designed.

The transition path thus involves both liberalization and administered changes. The idea of deregulation and liberalization is to use markets to provide the appropriate prices and other resource allocation signals. A very important aspect of this is liberalization of foreign trade—not only to increase choice but also to import competition to the traded goods sector. In the case of many 'big' prices, however, such as energy prices, the exchange rate, or interest rates, transition frequently involves *administering* them towards the levels 'appropriate' for resource-allocation purposes—often in stages. In principle, this might be done by liberalization and marketization, but it is often probably better done administratively. Even Poland's 'big-bang' strategy involved the phased alteration of, for instance, energy prices. And in China, reform has involved both gradual deregulation and liberalization (starting with agriculture) and a relatively slow move of important administered prices towards 'market' levels.

An even more fundamental choice is whether to rely primarily on the growth of new private-sector enterprises to effect transition—so that the relative importance of the old state sector diminishes—or to rely on transformation of the state sector itself. (Mayhew and Seabright, 1992). In practice, varying mixtures of strategies have been used. It is fair to say, however, that in eastern Europe considerable emphasis has been placed on the need for transformation of the state sector itself. Again, the contrast to China, which has relied mainly on the rapid expansion of TVEs (township and village enterprises)[9] is instructive. In eastern Europe, it is probably Poland that most closely matches the strategy of letting the *de novo* private sector grow, although, as Carlin and Landesmann note, there has also been considerable restructuring in the state sector.[10]

How to move the state sector towards efficiency and dynamism is another area where the answers are not clear cut. Much of the early academic literature (see the discussion in Carlin and Landesmann) was concerned with structures of corporate governance and incentives as an end-point—which tends to favour outsider privatization (domestic or foreign) as a model. Other literature, focusing on the incentives for managers to introduce change, may favour insider privatization. Here we note that there is little disagreement about the need for the sticks of competition and hard budget constraints (involving the performance of the financial sector) to speed the process.

Particularly difficult questions surround the banks and other parts of the financial system. There is general agreement that the banking system is crucial, not only in affecting incentives and allocation in the enterprise sector, but also in the transmission of macroeconomic policy. But how should the banks themselves be restructured and regulated? Many of the questions here are not dissimilar to the questions raised about financial-sector performance in developed market economies. Finally, all the countries we are concerned with face the problem of what to do with large, inefficient, and often declining firms or

[9] China does, of course, face increasing problems, for example of enterprise debt, arising in the SOEs (state-owned enterprises).

[10] Although there have been a number of 'high quality' privatizations and lots of 'small privatizations', the privatization of major state industries has been slow, especially as compared with the mass 'voucher privatization' in the Czech Republic.

sectors, such as coal, steel, and parts of heavy industry. Often there is little alternative to state-organized restructuring or sale to a foreign multinational.

Two key issues
Granted that there will be difficulties surrounding transition, the above still suggests that liberalization and restructuring should *raise* GDP, potential welfare, and growth. In China and Vietnam, this has, in fact, been the experience—but not in the countries we are concerned with, all of which suffered extremely large and sudden initial declines in output from which most have still not fully recovered. How is this puzzle to be explained? And is it right to accept the general consensus that large transformational recessions are 'inevitable'? This controversial issue is looked at further in section III.

The second major issue is whether marketization and liberalization will lead on to 'catch-up'. The whole idea of transition, especially if it involves such heavy costs, would look much less desirable unless the output and productivity gains at the end of the process were extremely substantial. But no country has yet conclusively demonstrated that output falls are followed by sustained rapid growth. And little is known in general about what structures make catch-up and convergence likely.

(ii) Macroeconomic Issues

All the countries we are concerned with have faced the need for drastic macroeconomic stabilization as part of the transition process—though, as noted, the timing of major macroeconomic disequilibria has varied a lot. The 'classic' situation of near hyperinflation *at the outset* tackled by a 'big-bang' strategy of macro-restraint and market liberalization really applies only to Poland (moreover, as we see in section III, the conventional story needs substantial qualification). Most of the economies have run into serious stabilization difficulties *in the course of* transition. And these have taken various forms, depending on circumstances and policy responses—high inflation, budgetary imbalances, balance of payments crises, pressures on the exchange rate, etc.

By and large, as Ellman notes in his article, 'Washington consensus' policies of fiscal and monetary restraint have, where seriously applied, been surprisingly successful in bringing down inflation. There is also a developing body of cross-country comparative evidence suggesting that the stabilization of inflation is necessary for recovery. Begg, in this *Review,* defines successful stabilization as inflation less than 40 per cent, (see also Bruno and Easterly, 1995; Fischer *et al*., 1996), noting also that the typical pattern was that the lowest point of output preceded the peak year of inflation. But, clearly, containing inflation can be only one of the aims of macroeconomic policy.

The goals of macroeconomic policy in transition
In both transition and market economies alike, the need for macroeconomic policy arises essentially from two coordination problems which directly impinge upon the economy's financial stability and overall balance. The first is that the sum of individual actions may lead to an excess or deficient amount of nominal spending in relation to supply.[11] The second is the coordination of expectations—especially, but not only, that of inflation. Under an extreme version of central planning, the first is solved by the planning mechanism, the second by control over wages and prices. In practice, of course, a situation of suppressed excess demand (suppressed inflation) was common.

In a market economy, the problems have to be solved in a more indirect way. The 'authorities', taken to mean the consolidation of the government and the central bank (see Buiter, 1996, for a discussion of why these should be taken together), have two principal types of instruments available—monetary and fiscal. Possible monetary instruments include the supply of base money and, especially, influence over interest rates.[12] Fiscal policy is concerned with government spending, revenue, the balance of the budget, and its financing

[11] In standard, closed economy, models, the interest rate should clear the goods market at full employment. The case for macroeconomic policy arises in the presence of market failures (coordination failures) requiring intervention to set the appropriate interest rate.

[12] In standard models, the authorities can control either base money or interest rates. In practice, the trade-offs are considerably more complex.

(open economy issues are further considered below).

But while the control centre for macroeconomic policy is the government (the authorities), it would be quite wrong to see such policy as being only about control of the public sector (as often put forward in contemporary discussion of policy). The *real* objective of macroeconomic control is to control the economy. This, of course, includes the avoidance of destabilizing actions by the public sector itself—all too common—but it involves much more than that. For example, the monetary/fiscal authorities would be quite wrong not to take into account a major change in private-sector behaviour in setting interest rates and the budget. And some interventions, such as changes in banking-sector regulation, can have large macroeconomic effects.

The idea that sound macroeconomic policy is simply a matter of rules for public borrowing and the money supply, with the private sector effectively controlled by hard budget constraints and commercial behaviour—fostered by the 'Washington Consensus'—is no doubt often justified in practice where the main problems emanate from government. But there is little basis for it in theory and, during transition especially, there are plenty of other changes going on that emanate from the private sector.

Private-sector shocks and policy responses

As an example of such sudden changes in behaviour by the private sector, take an investment boom by profitable, solvent enterprises, financed by bank borrowing. This could easily lead to excess demand and inflation (or balance-of-payments problems) without violating any of the principles of good banking. The situation could be described, simply and conventionally, as excessive growth in investment not balanced by a reduction in consumption, or, in more financial terms, as an excessive provision of financial assets to households and enterprises, leading to an inflationary excess demand for goods (or balance-of-payments problems in an open economy). In such circumstances, there would clearly be a presumption for government intervention (in the form, for example, of a tightening in monetary policy or, possibly more desirably, a budget surplus).

Similar difficulties, and similar needs for intervention, could arise from problems of liquidity management. It is sometimes insufficiently appreciated that, in transition economies, the assets held by the public are mostly relatively liquid—for example, currency and short-term bank deposits. This is a natural result both of financial underdevelopment and of instability. The pre-transition economies tended to have a high volume of liquid assets, a situation often described as a 'monetary overhang'. The volume of liquid assets is low in countries, such as Poland, where the overhang was eliminated by inflation, but is high, for example, in Bulgaria.

Consider an individual agent who holds a stock of cash and bank deposits. The key question is under what conditions will that stock continue to be willingly held, and what behaviour results if the asset demand becomes unstable. The simplest case would be an attempted flight into goods, triggered perhaps by expected inflation, leading to both shortages and inflation. Another possibility is a flight into other assets—for example, into shares, if they exist, or into real estate. Or the flight could be into foreign currency. The latter is particularly likely if there is a perceived risk of default. A flight from government bonds is also possible (and has happened recently in Bulgaria) if the government itself is perceived to be potentially insolvent. In this case the problem expresses itself as extremely high interest rates on government paper.

The authorities have several options available if they want to deal with (potentially) excessive liquidity. One, which was taken in all the countries we are concerned with, is simply to allow 'corrective' inflation—ideally a jump in the price level. Paradoxically, a large stock of nominal domestic government debt can actually be helpful, since the wealth effect on the private sector—basically the inflation tax—is increased.[13] Another policy, available in principle, is to work on the components of inside money, e.g. by credit controls, or by reserve ratio changes, or special deposits. A third is some form of open market operation, replacing liquid deposits by less liquid ones—the paradigm case being the sale of government bonds to the *non-bank* private sector (note, however, that this would fail if the non-bank

[13] Foreign debt, however, presents real difficulties (especially for the budget) as its value in terms of the domestic currency and the value of debt service payments increase with depreciation of the exchange rate.

private sector borrows from the banks to buy the bonds). Privatization, in the sense of sales of shares to the non-bank public, lowers liquidity in the same way that sales of government bonds do—again with the *caveat* that the purchases are not financed by increased bank lending.

Especially as banking systems and arbitrage opportunities develop, the principal way of dealing with 'potential liquidity' is interest rates. A natural response to increased expectations of inflation is to stabilize behaviour by increasing the benefits of staying put. Likewise, higher domestic interest rates are a natural response to capital flight and downward pressure on the exchange rate. Indeed, central banks more and more gear their interest-rate policy to such factors as asset price inflation or the external sector.

There are several problems, which, while general, are particularly important during transition. The first is that it may be quite difficult to target deposit rates—which are largely set within the banking system—because banking-sector spreads may be high and variable especially in crisis periods (see Steinherr, in this *Review*, for a discussion of spreads at the start of transition). The banking sector itself is highly imperfect.

The second is that interest rates also have a major effect on investment incentives and there are serious potential policy conflicts between the requirements of flow and financial stock equilibrium. Indeed, this is only part of the problem. Longer-term growth objectives might require another interest-rate policy, and exchange-rate considerations, yet another. One instrument bears on too many policy objectives.

The third is that much financial instability arises from perceived default or solvency risk or from perceived policy inconsistency. Though interest rates and asset prices will be affected, and interest-rate policy may be helpful, much more fundamental institutional, regulatory, and policy changes are normally required. As many examples (e.g. Mexico) make clear, there is no guarantee that financial market responses will be helpful.

The above, largely theoretical, discussion suggests a number of macroeconomic problems and potential instabilities that are likely to face policy-makers engaged in transition. It is clear, however, that the role of macroeconomic policy changes in the course of transition. At the beginning, there is a heavy emphasis on stabilization, often from a very difficult starting point. Macroeconomic and microeconomic phenomena may interact unfavourably and can hardly be separated. Later on, for the more successful countries, the classical dichotomy between financial stability, on the one hand, and 'the supply side' begins to make a bit more sense. But, as industrialized country experience shows, serious conflicts between objectives are still likely to arise, which, with limited instruments, pose difficult policy choices. And there is a continuing need for control to maintain stability as well as to offset shocks as they arise. And between macro control and the supply side lie all the difficult issues concerned with corporate governance, the structure of the banking sector, and the other institutions that are necessary for a well-functioning market system. As these change, so does the role and scope of macroeconomic policy.

III. TRANSITION ISSUES

This section builds on the previous outline of the stylized facts by looking at some particular issues. The approach is selective, and draws where appropriate on the other articles in this *Review*.

(i) Stabilization and the Initial Output Falls

The question of the reasons for the extraordinarily large initial falls in output in the eastern and central European countries undergoing reform remains highly controversial. There is little doubt, despite large measurement difficulties, that they happened.[14] Were they inevitable, in which case the consequences of output decline should be taken into account in the

[14] For some of the more successful reforming countries, such as Poland, there has been a tendency to discount the falls. Not all the measurement biases go one way, however, and welfare qualifications, such as the reduction in queuing, need themselves to be qualified by other changes, such as a more unequal income distribution, increases in poverty and unemployment, etc. For a scathing view, see Kolodko and Nuti (1997).

design of any initial stabilization policy? Is it true, as is often argued, that gradualism just postpones needed pain—or 'creative destruction', as Gomulka (1997) puts it? More generally, what do these episodes tell us about microeconomic and macroeconomic policy for transition? And there is the nagging question as to why China and Vietnam have been so different.

There is no shortage of potential explanations. Kornai (1994) sees transformational recessions as, in large part, due to the replacement of one system by another. Blanchard (1997) also gives weight to what he calls 'disorganization', but puts the main stress on relative price changes owing to the reduction of subsidies and price and foreign trade liberalization. Others have put weight on excessively tight policies, or on 'credit crunches' (see Calvo and Corricelli (1992), discussed by Begg in this *Review*), or on the impact of shocks, such as the break-up of the Council for Mutual Economic Assistance (CMEA), or even on the Gulf war. There is probably truth in most of these, and different factors no doubt have different weights in different countries and at different times (thus, the collapse of trade was much more dramatic in the former Soviet Union).

Here we are concerned with a more basic analytical issue. That is, what would one expect the macroeconomic results of 'big-bang'-type price liberalization to be in a situation where most enterprises were previously state-controlled? The reason for focusing on price liberalization is that this seems to be the common thread linking the output declines. Macroeconomic policy and the initial macro-disequilibrium varied: the examples of Czechoslovakia and Hungary are typically cited as indicating that macrostabilization was not the origin of the output fall. The shock from the collapse of the CMEA comes too late to explain the output fall in Poland, which occurred, almost instantaneously, in the initial months of 1990 (though it can help to explain the further output decline in 1991). Thus, the Polish case is crucial in that it is the most 'pure' and clear-cut (it has also been used to try to sort out the relative importance of the CMEA and other shocks—see discussion in Gomulka, 1997).

Polish 'big bang'

First, it is necessary to dispel the myth that the strategy in Poland was a 'big bang' involving reform, macroeconomic tightening though subsidy reduction, micro-liberalization and exchange-rate convertibility, all at the same time at the beginning of January 1990. There had been considerable liberalization and reform before then. Most importantly, food prices had been freed and subsidies reduced in the summer of 1989.[15] Combined with indexation of wages in industry, this had generated very high inflation (effectively of a cost-push or competing-claims type). Yet, this had begun to fall in the last months of 1989 (Gotz-Kozierkiewicz and Kolodko, 1992). In fact, most of the budget deficit of 1989 had been recorded in the first half of the year. By the fourth quarter of 1989, the budget was reasonably well controlled (helped by the reduction in subsidies), with the result that the money supply in relation to GDP was drastically reduced. Poland was effectively 'demonetized' or, at the very least, the monetary overhang was wiped out. In other words, the administered price changes, liberalization, and exchange-rate measures came in the context of an economy which was already illiquid. The effective fiscal deflation owing to 'big bang' itself was also smaller than the standard year-to-year comparisons suggest.

The results of the January shock are not in dispute. There was an immediate rise in prices of about 30 per cent above the level that would have been expected on the basis of past trends and the administered price changes introduced, and an immediate fall in output of a similar order of magnitude. Real wages fell by about 30 per cent and there was a similar fall in real household expenditure. Revenues and profits were maintained, which is one reason why the budget moved to unexpected surplus.[16] In essence, one can think of the impact as 'like' an indirect tax hike, levied, in this case, not by the government but by enterprises. As with other supply

[15] Prior to this, there had been food shortages, exacerbated by the expectation that agricultural prices would have to rise.

[16] Profits formed a large part of the tax base. There were other reasons for the maintenance of profits in 1990, including, for example, devaluation gains and destocking—stocks, especially of raw materials, had risen partly in anticipation of the price-raising effects of 'big bang'.

shocks, the results were price raising and output reducing.[17] The question is, why did it happen?

One possibility is that it simply represented a move, by enterprises with monopoly power, to profit maximization behaviour. That monopoly power was used is not in doubt: profit maximization would, however, have involved massive lay-offs as well, which did not happen. Another is that the very large devaluation simply led to traded goods prices rising. There is no doubt that under-valuation was part of the story (monthly wages, measured in dollars, were reduced to about $50–80 in the initial phase of 'big bang'). What undervaluation meant was that the effect on competition of freer trade was offset by the exchange-rate policy. Another story is that the generalized price rise was simply a defensive reaction to the assumed effects of 'big bang'.

The policy was pre-announced, and it appears that, in broad terms it was 'credible'.[18] It seems probable—though difficult to prove—that enterprises really did believe that budget constraints would be hardened, and interest on borrowed money would have to be paid if they were to survive. In evidence, wages initially fell well below the officially sanctioned norm under the tax-based incomes policy (*popiwek)*. But the initial response was monopolistic, and price-raising, rather than attempted structural adjustment. And, in Poland, the decline in wages in relation to producer prices was temporary.

An additional factor is well illustrated by the Polish case. Tight monetary and fiscal control at the time of 'big bang' led to extraordinary spreads within the banking system. Data from the National Bank of Poland suggests that the lending rate in January 1990 was about 47 per cent. The rate on time deposits (of less than one year) was of the order of 22 per cent. Thus the 'spread' was enormous, at about 25 percentage points—*per month*. This amounts, in effect, to a very large 'tax' on the private non-financial sector. It is difficult to resist the speculation that enterprises simply reacted to high interest rates (and the assumed hardening of the budget constraint) by raising prices and passing on the burden to households, an extraordinarily perverse reaction to monetary and fiscal tightening.

The main point being made is that the initial microeconomic response to price liberalization and the announced commitment to fiscal and monetary control was perverse, and not at all as expected (at least according to official forecasts). A policy which was intended to produce rapid restructuring and efficiency gains, was initially avoided by generalized price-raising behaviour, which was good for the budget but not much else. And as enterprises survived the initial shock, they quickly reverted to type: wages rose relative to output prices during the year, even to the point that many enterprises paid the sharply progressive 'inflation tax' under the incomes policy in force. Spreads fell and enterprise borrowing resumed.

The rapid rise in wages during 1990 against the so-called nominal anchor of a fixed exchange rate meant sharply worsening competitiveness. The exchange-rate regime was changed to a (hard) crawling peg early in 1991. Poland then faced more 'normal' transition problems of a declining tax base (due to squeezed profits) with problems for the budget and differentiated pressure to restructure, offset (in many cases) by continued ability to borrow from the banks or to extract support from the budget.

A general phenomenon?

There is of course, much that remains controversial about the Polish case. Here we are concerned about the more general implications. Price rises were generalized across Eastern Europe. Their effects, however, varied depending on the response of other variables. In those cases in which real wages fell markedly, it is natural to see the output falls as partly driven by demand, even though the ostensible cause was the price rise (Bulgaria and Czechoslovakia seem to fall into this category). In other cases, however, (e.g. Hungary) it was producer prices that rose, with relatively little fall in the consumption wage and a purely demand-led explanation seems less compelling (Poland, as seen earlier, was a hybrid of both responses).

[17] In the simplest case, where aggregate nominal spending remains unaffected, the result would be equal and opposite proportional changes in prices and output (with no change in revenue for enterprises as a group)—not far from what happened.

[18] It has already been noted that anticipations affected stock-building. They also affected the demand for foreign currency and hence the parallel exchange rate (legal).

External features were also important. All the countries were affected by the ending of the CMEA, with the negative demand shock particularly important for Bulgaria and the Baltics. On the other hand, the exchange-rate regime, at least initially, played an inflationary role. Widespread undervaluation meant that there was little restraint from international competition—possibly even a reinforcement in so far as some prices were raised to match import prices. As exchange rates 'hardened', some direct 'crowding out' of exports and import substitutes owing to competition began to appear. When wages began to rise more rapidly than productivity, the downward pressure on output was reinforced by a tightening of monetary/fiscal conditions (in Poland, one response gave way to another, followed by some relaxation of the exchange-rate anchor; in Hungary in 1995–6, and in the Czech Republic more recently, policies were tightened sharply and exchange rates devalued).

An interesting feature of the price liberalization in virtually all the countries of the area was the extent to which it operated like a tax increase. First, inflation itself operates as a tax on non-interest bearing money (or seigniorage, see Budina and van Wijnbergen in this *Review)* and more generally on domestic nominal assets if interest rates do not match inflation. Inflation itself facilitated reductions, at times substantial ones, in money and debt stocks. Second, we have suggested that liberalization led to a kind of 'indirect tax' levied on households not by the government, but by large monopolistic enterprises raising their final good prices. This was highly adverse for inflationary expectations and produced an additional shock to real expenditure and output since the response was defensive and did not lead to increased investment. In due course, despite the initial response, tight controls on the money supply and fiscal positions should lead to disinflation and output recovery, but the process can be (and has been) very slow.

What these various arguments appear to illustrate is this. Contrary to the widespread view (partly based on Polish experience) that price liberalization is disinflationary and an important part of a stabilization programme, the initial effects on prices can be perverse. Similarly, the view that macroeconomic restraint will bear down on inflation via price lowering behaviour, is hardly borne out. Macroeconomic restraint *per se* does little to increase competition and, without intense price competition, inflation is unlikely to fall. Indeed, if there is a real exchange-rate depreciation, a further anchor is removed. With pricing power still concentrated in the large state sector, neither demand falls nor tightened budget constraints necessarily produce the correct responses on the price front. Yet output still declines very sharply in reaction to tight policies, CMEA collapse, and, at least in some cases, pronounced real wage falls.

(ii) The External Dimension

The successful central and eastern European reformers have consistently sought to ally themselves with, and open up towards, the West, particularly the EU. In terms of political economy, such aspirations may be important in improving the general credibility of the transition strategy and in keeping it on course. Since the crucial role of openness is generally recognized, only a few points need to be made.

Going back to the microeconomics of transition, modern theory would add to the normal gains from trade owing to specialization, a heavy stress on the potential gains from competition. This aspect of openness is particularly relevant to transition economies. The force of competition is crucial both in stimulating the desired microeconomic responses and in improving macroeconomic transmission mechanisms which depend upon the microeconomic responses. There are, however, trade-offs. In practice, the countries we are concerned with, simultaneously with the launching of stabilization programmes, introduced exchange-rate convertibility, reduced tariffs, and liberalized their trade regimes. At the same time, however, most of them adopted exchange rates which appeared initially undervalued—thus attempting to square the circle of introducing competition and remaining competitive.

Liberalization and incentives

The policy of trade liberalization was surely right. The aim was to introduce microeconomic signals corresponding to international prices into the domestic economy. Such policies were supported by the movement of administered prices (in stages) to be in line with international prices. This was an essential part of the general strategy of removing distortions so that markets can work. Even so, pragmatically, some sectors are likely to need protection (for a temporary period, it is hoped) and elements of protection have been reintroduced in most countries. In line with the general strategy, tariffs were reduced unilaterally to low levels. Here, too, pragmatism has meant that there have been some reversals—mainly for revenue reasons owing to pressure on the budget (in a second-best world, if tariffs can be made non-discriminatory, they may be a useful and reliable source of revenue).

There is another issue that illustrates the interconnectedness of transition policy. If a sector subject to international competition simply borrows to remain in business, then not only are the incentives not working, but this behaviour can contribute to monetary growth and inflation. This puts the focus back on to the banking system and the need for hard budget constraints. But if pressure to support a particular sector is irresistible, it also indicates that there can, in practice, be worse responses than tariff protection.

The exchange rate

The countries of eastern Europe went mostly for relatively low exchange rates when they introduced current account convertibility. Poland, for example, chose a level close to the parallel rate, which would normally overstate the degree of devaluation necessary on unification of the markets; Czechoslovakia devalued in stages during the first year by about 95 per cent; the Bulgarian and Romanian depreciations were even higher. (Hungary chose a harder exchange-rate policy, partly because of foreign debt service effects on the fiscal deficit—in contrast to Poland, Hungary was not prepared to go for debt rescheduling since it wished to continue to benefit from foreign investment inflows.)

A low exchange rate, which effectively means low domestic wages measured in foreign currency, is obviously helpful in giving profitable opportunities to newly liberalized enterprises in the export sector, but also, as argued above, reduces the forces of competition. Over time, for the recovering countries, there has been a strong tendency for wages to rise, strengthening competition but lowering the profitability of tradable production. The dilemma is clear. An undervalued exchange rate is good for net exports, but bad for inflation and competition.

The extreme version of a hard exchange-rate policy was in the former East Germany on reunification. At the one-to-one conversion rate, wages in the East were about half those in West Germany. Even this did not prevent a wage rise over time to about 70 per cent of the West German level—which implies wages higher than in much of western Europe. At such a rate, very little of the industrial base in the eastern *Länder* was viable: the policy was only possible with huge transfers from West Germany.

By contrast, monthly wages in Poland were barely above \$100 in 1990 (and much lower than that at the beginning of the year). In 1991 in the Czech Republic they were about \$130 and in Hungary about \$190, with Bulgaria at just \$50. (IMF, 1997). Thus, the region was an extremely low-wage area within the European economy. Opportunities for profitable exports and investment were clearly present. Wages, measured in dollars, have since risen quite rapidly (they have tripled, for instance, since the start of reform in Poland and in the Czech Republic). Much of the rise has been matched by increases in productivity, but, despite this, there is no doubt that competitiveness issues are rising to the top of the political economic agenda.

Trade performance

The problem of trade came to the fore with the disintegration of the CMEA which forced the ex-satellite countries to reorient their trade patterns. As Brenton and Gros show in their article, the trade shock was particularly devastating in the case of the ex-Soviet republics. At the lowest point, countries such as Armenia, Azerbaijan, Georgia, and Latvia practically stopped trading. The central European countries were less affected. The decline in trade was about 25 per cent in Czechoslovakia, about 15 per cent in Hungary, and less than 5 per cent in Poland.

Some experts attribute to the disintegration of the CMEA a major role in explaining the collapse in output across the region. There remains a question, however, as to whether this should be regarded as an exogenous or endogenous factor—it is probably a bit of both. There is no doubt, however, that all the transition economies had to rebuild and reorient their trade patterns. For those countries that embarked on serious reforms, trade performance has been astonishing—Brenton and Gros argue that most of the reorientation had been achieved by 1992.

Two interesting questions come up in the context of the trade collapse and reorientation. First, has the emergence of new trade patterns, heavily tilted towards Western markets, been associated with product upgrading? Second, how much more adjustment still needs to be done before reorientation is complete? The first question stems from the commonly held belief that intra-CMEA trade involved products of low quality, not suitable for highly demanding Western markets. Brenton and Gros search for evidence indicating improvements in quality, but find none.

The question of product quality also figures in the paper by Carlin and Landesmann. They establish that in several vertically differentiated sectors, eastern European exports to the EU occupy the lower end of the quality spectrum, effectively in the same niche as EU imports from Turkey, India, and China. However, they present evidence that the Czech Republic, Hungary, Poland and Slovenia are climbing the quality ladder. The same, however, cannot be said of Bulgaria, Romania, Slovakia, and Russia. In fact, in the latter group, it seems that a reverse process is taking place.

How much export growth and trade reorganization can be expected to occur in the near future? There are high hopes that central and east European exports to the EU will continue to grow at double-digit rates. If Brenton and Gros are right that most of the trade reorientation has already taken place, then this could prove over-optimistic. In fact, trade data for the most recent years clearly show that even the most successful reformers have had difficulties in maintaining rapid expansion. Exports have stagnated and even faltered, while the pace of increases in imports has accelerated significantly.

(iii) Macroeconomic Policy

Macroeconomic policy is discussed in the articles by Budina and van Wijnbergen (fiscal policy) and Begg (monetary policy). At the beginning of transition it was natural that the focus of macroeconomic policy—both fiscal and monetary—should have been on stabilization. With the onset of recovery, that is Stage II in terms of the classification of the Introduction, rather different issues come to the fore, including problems of capital inflows and problems emanating from changes within the private sector. As reform and integration into the world economy proceed, the issues surrounding monetary/fiscal and exchange-rate policy are increasingly the same as those facing other countries, whether developed or developing.

Stabilization

There is not much dispute over the need for fiscal and monetary stringency in order to bring down high inflation once it has started, nor over the proposition that high fiscal deficits and rapid monetary growth fuel and may cause inflation. It is also generally agreed that, at least for countries with underdeveloped capital markets, the prime need is for fiscal control: without it, monetary or exchange-rate control is likely to be short-lived. Budina and van Wijnbergen present evidence that those countries that got their deficits into a sustainable position succeeded in controlling inflation and generating recovery and that, by and large, those that did not, did not succeed.

From a policy point of view, however, it is necessary to go behind these propositions. It is possible to think of a situation where the private sector is functioning well and the single problem is an irresponsible government which spends too much, runs a large budget deficit, and generates inflation (Poland in the first half of 1989 roughly fits this description). The policy prescription is then simple: curtail spending and deficits and hope that adjustments are quick (even in this case, there is an issue about the speed of policy change: for example, if there is nominal inertia in price and wage changes, there may be a case for gradualism). The situation faced by most transition economies was nothing like so clear-cut.

First, in many countries there was a monetary overhang which is difficult to get rid of without inflation. Second, the anticipation of inflation itself tended to destabilize monetary holdings, making the problem worse. Third, many of the initial fiscal moves were price raising, thus fuelling inflationary expectations, a situation exacerbated by some of the private-sector responses to interest-rate rises and hardening budget constraints. Fourth, most countries were affected at the beginning of transition by the partially exogenous shock of the ending of CMEA (the only exception was Poland). Fifth, the budget itself was adversely affected by all the other things going on (e.g. output declines, a falling tax base, difficulties of revenue collection, and automatic increases in expenditure under some welfare programmes). In short, budget deficits were highly endogenous to the reform process and private-sector responses.

What this means is that control of the budget is extraordinarily difficult and is unlikely to be achieved initially. What matters is that a 'sustainable' position is reached over time, and, looking forward, that the government appears committed to achieving sustainability and has a credible strategy. Budina and van Wijnbergen describe aspects of the fiscal policy response in Poland and Romania as examples of successful and unsuccessful strategies.

But what is sustainability, and what is credibility? The obvious meaning to give to fiscal sustainability is debt to GDP ratios that do not explode, that is, that are expected to converge to some tolerable level. Budina and van Wijnbergen, for their calculations of sustainable primary deficits, make assumptions about seigniorage revenues (which depend on assumed inflation) and then postulate that the debt to GDP ratio is to remain constant at its existing level. As is well known, the parameter that matters for debt dynamics is the difference between the real interest rate and the real rate of growth, about which they prefer to make illustrative assumptions rather than using actual values from the past (though they note that for Poland the difference over the last 5 years has been strongly negative). Their measures provide a useful, if somewhat crude, reference standard with which actual primary deficits can be compared. What matters, of course, is not actual deficits, but expected future deficits. The credibility of a strategy, given its dependance on future reforms, tax, and expenditure changes is, essentially, a political matter. Is the government committed to a sensible set of policies, and are they likely to be able to implement them?

For policy purposes, it is useful to cut through the detail, and focus not on deficits but on debt itself. The lesson, with which few policy-makers would disagree, is that macroeconomic strategy needs to ensure that debt ratios do not explode. If it looks to private-sector agents that the strategy is not consistent in this sense, then, the argument goes, all sorts of trouble, such as high interest rates or inflation will occur, owing to anticipations, in the short term.

By far the most difficult problems for fiscal policy were due to the initial output declines, which affected revenues and put pressure on expenditures, and due to further declines in the tax base owing to the reform measures themselves (e.g. the reduction in tariff revenue due to external liberalization). Another factor, important in some cases, was the increased fiscal cost of foreign debt service owing to exchange-rate declines.

Given that the extent of shocks (e.g. due to the collapse of the CMEA and endogenous to the reform process itself) varied so considerably, and given that fiscal positions are highly endogenous, what is to be made of the observation that it was the successful countries that achieved fiscal sustainability? The observation is certainly suggestive, but the causality, as usual, remains in doubt. What is not in doubt, is that the successful countries did manage to raise revenues and control expenditure and to bring their deficits under control.

An interesting question is whether those countries that adopted fixed exchange rates as a nominal anchor during transition were more successful at stabilization than those that floated. Budina and van Wijnbergen argue that, once fiscal stance is taken into account, there is little difference. Begg is similarly sceptical of the conventional wisdom favouring pegged exchange rates, pointing out that they were only an option for those likely to succeed, and that monetary targeting also seemed to be helpful. In fact, more than one nominal anchor was frequently adopted at the start of transition.

Open economy dilemmas

At the start of transition, countries appeared to have some freedom to target and control separate parts of the financial system (e.g. credit aggregates and interest rates, or the domestic money supply and the exchange rate). With deregulation, reform, and increasing openness, such freedom has been progressively constrained. Clearly, fiscal policy can still be used, though the room for manoeuvre is limited in most countries. On the monetary side, the main policy tool becomes the short-term interest rate—which may be geared towards the control of money or the exchange rate, or some other objective. The limited number of instruments raises potentially serious policy conflicts (e.g. between internal and external objectives). These conflicts also arise, of course, in developed market economies.

First, countries such as the Czech Republic have run into trouble by, effectively, trying to target both the exchange rate and domestic money aggregates. Capital inflows were fought by sterilized intervention, at considerable cost. That the authorities were right to be concerned is demonstrated by events. A crisis which started off as capital inflows and upward pressure on the exchange rate ended up with a balance-of-payments crisis and devaluation. Essentially, the problem is one of arbitrage: if the exchange rate is to be controlled, domestic interest rates have to be set accordingly. But those interest rates may not appear appropriate from the point of view of the domestic economy. Alternatively, the strain has to be taken on the exchange rate (Begg recommends relatively wide exchange-rate bands to discourage speculation). Fiscal policy can help to square the circle but there are considerable difficulties in practice since it is not flexible enough to offset a speculative inflow directly: rather, its use is to offset the demand effects of higher interest rates.

Openness to the international economy also impinges more directly on macroeconomic balance. First, the opportunity, as creditworthiness develops, to borrow abroad and import investment goods, is unequivocally an advantage (normally there would need to be a concomitant rise in the real exchange rate to divert domestic expenditure to imports). At the same time, however, the possibility of foreign borrowing undoubtedly lessens the scope for domestic monetary control and makes runaway booms more likely. The dilemmas appear sharp if the authorities also have objectives for competitiveness. And experience (e.g. of Mexico or Thailand) suggests that international flows of funds and credit are fickle, so that there are clear risks of an exchange-rate crisis if the trade deficit is allowed to worsen. In both the Czech Republic and Poland, sharply rising deficits reflected booming domestic demand which it was difficult to control without violating other objectives such as competitiveness.

While some of the problems reflect inconsistent policies, there are genuine dilemmas. From a growth point of view, the experience of many countries (especially in Asia) suggests the benefits of openness combined with the maintenance as far as possible of a ‘competitive’ exchange rate. But such a policy risks generating domestic overheating and speculation. The latter (in the absence of stringent capital controls) more or less requires rapid interest-rate (and exchange-rate) responses. The former is more medium-term in nature and, in principle, can be helped by fiscal and other measures to increase domestic savings. But policy-makers still have fewer instruments than they would like.

(iv) Financial-sector Reform

One implication of these developing macroeconomic difficulties that would be widely accepted is that they point to the need for continuing microeconomic and, especially, financial-sector reform. Not only are speculative booms and busts less likely to occur if the financial system is working well, but the consequences of reversals (e.g. of foreign inflows) are less damaging if the banking sector is strong. In the worst case, macroeconomic difficulties of the type described, combined with fragile and poorly regulated banks, threaten solvency and generate systemic risk of financial instability.

In principle, a tightly regulated and controlled banking system could provide an extra ‘instrument’ helping to solve the policy dilemmas. As a clear example, credit controls, if they were in place, could be used to help manage investment and demand, providing more scope for interest-rate policy to target other aspects of the economy—such as the exchange rate. Even in developed banking systems, 'availability' effects can be powerful: reserve ratio changes, special deposits, and other devices to manage banking-sector liquidity, and hence credit availability, are still part of the armoury. The usefulness of these methods of control is one of the reasons why many observers suggest that finance should be liberalized relatively late, often pointing to experience in the Asian newly industrialized countries (NICs). Such control, however, is increasingly threatened by alternative channels of intermediation (the development of capital markets, for instance, loosens the influence of the banking system on investment). Growing arbitrage possibilities mean that monetary policy becomes more and more indirect, via interest rates—and, with a fixed exchange rate, even that control is lost. The successful transition economies are joining a world economy where the potential for arbitrage is already very great, unless blocked off by regulations—such as capital controls—the effectiveness of which is threatened by the same forces of financial integration.

The banking system and its problems are discussed in the article by Steinherr in this *Review*. Broadly, the development of the banks in eastern Europe has been very different from the 'Asian model' of tight control and gradual liberalization. Effectively, the banks were decontrolled and told to behave like commercial entities along with the general policy of early liberalization. Many started with a loan portfolio which was arbitrary, containing a large share of doubtful or non-performing assets, and any subsequent restructuring has been insufficient. Not only were the existing banks inexperienced, but in a number of countries new ones were allowed to start up with inadequate supervision. As Begg notes, it is the problem of new bad loans, incurred after reform, that is really worrying. Not surprisingly, there have been a number of crises. The situation could be characterized as one of fragile banks, with insufficient competition, weak supervision and inadequate regulation. Perhaps the adage for eastern Europe should be 'regulate early' rather than 'liberalize late'.

Quite apart from the microeconomic distortions, a fragile and uncontrolled banking system poses real threats to macroeconomic and financial stability. Budgetary control is about the solvency of the public sector. It is not enough. The solvency of 'private-sector' financial institutions is also a potential threat (and it is not just the banks that impose risks, as the example of the collapse of pyramid selling in Albania illustrates).

The kinds of problems that can ensue are well illustrated by the recent case of Bulgaria. According to the OECD (1997), the budget was reasonably well controlled in 1994 and 1995—but at the expense of social policy. The primary, or non-interest deficit is in large surplus. Problems of the banking sector led, however, in 1996, to a flight from bank deposits, which was followed by large increases in interest rates on government instruments. Given relatively large amounts of government debt outstanding, budgetary control and even the solvency of the government was threatened. A flight from domestic assets to foreign currency led to a tumbling exchange rate.

In Bulgaria, the suggested solution to the crisis was the drastic one of a currency board—effectively a fixed exchange rate with changes in the monetary base only possible with foreign inflows swelling foreign reserves—together with an IMF programme of support. It is an extreme form of nominal anchor, with no possibility of government borrowing from the central bank. (It does not rule out other forms of budget finance.) It is clear that the success of such schemes depends crucially on other aspects of financial policy: control over the budget and, especially, tight regulation of the banks. It also needs some way of dealing with an essentially insolvent banking sector.

(v) Institutional Change

All the countries we are concerned with carried out wholesale policies of deregulation, liberalization, and opening to foreign trade. We have already seen that, for the successful reformers, the trade response was extremely impressive—an indication, perhaps, of the extraordinary degree of distortion in most countries prior to reform. We have also suggested that some of the initial responses of the state-owned enterprises were, from a macroeconomic point of view, difficult to deal with. The responses reflected the lack of competition, an inadequate banking system, and the incentive structure within enterprises themselves.

The restructuring of enterprises towards more efficient and more dynamic forms is ultimately what transition is all about. In part, this involves developing the forces of competition and hard budget constraints. But, crucially, it also involves changing ownership and governance structures (especially via privatization) in order to encourage what Carlin and Landesmann call 'strategic-active-deep' restructuring rather than 'defensive-reactive-shallow' responses.

The issues surrounding changes in governance and performance are comprehensively surveyed by Carlin and Landesmann. Broadly, all the successful reformers, especially the Visegrad countries, have succeeded in substantial restructuring: productivity and trade performance have improved. But the experience of privatization does differ, with mass privatization in the Czech Republic, privatization based rather largely on foreign investors in Hungary, and delayed privatization for most of Polish state industry. As the authors note, it is early days to draw strong conclusions about the best 'model'; privatization is endogenous to the reform process and the situation differs enormously between countries. There are some puzzles, though, such as the observation that high investment rates in the Czech Republic, commonly seen as an indicator of strategic responses, seem to have gone with relatively poor productivity performance. They also note that voucher privatization, also in the Czech Republic, does not appear to have led, as feared, to dispersed share ownership and ineffective governance.

It may be tempting to conclude, since most of the central European countries have restructured and done well on trade, that privatization and ownership reform do not matter very much. Such a view would, however, be premature. Much of the improvement so far has been defensive, and has involved getting rid of the grosser sorts of obvious inefficiency. Questions of the efficiency (especially the dynamic efficiency) of different forms of ownership and control have yet to be fully tested.

With underdeveloped capital markets, the banking system in eastern Europe is, as argued by Steinherr, bound to remain important in the finance of enterprises and in corporate governance. In the Czech Republic, mass privatization has led both to cross share-holdings in the banking system and the involvement of the banks in the Investment Privatization Funds. Also, the National Property Fund is the main shareholder of the main banks (OECD, 1996). The interlocking structure may lead to a German-type banking system. Generally, institutional arrangements are quite variable, and so are the procedures that have been adopted to restructure banks' balance sheets (for inherited non-performing loans, or for rescues).

The key point is that, for the most part, banking-sector development remains a priority, not only to avoid macroeconomic instability, but also to improve the distribution of credit to potentially profitable enterprises.

Finally, what about social expenditure and distributional issues? There is no doubt that, in all transition countries, the social costs have been very large. Many commentators have been surprised that populations and electorates have been prepared to put up with so much. Here, since we cannot begin to do justice to the issues, we want to make one major point. This is that the really large social costs (including a 'crisis of mortality') have occurred in those countries, especially in the former Soviet Union, where the decline in output has been very large. With huge and prolonged depressions, and massive pressures on the budget, there was no way that social expenditure could be maintained—a familiar enough story. By and large, the countries that have done best have managed to maintain the social infrastructure, if not intact, then at reasonable levels. There are, of course, immense problems,[19] but the best chance of their solution starts with a continuation of recovery and growth. In the case of one important area of policy, the labour market, Boeri, in this *Review*, makes the point that the success of Czech labour-market policies owes a great deal to the fact that they avoided the sharp rise in unemployment that hap-

[19] In several countries, the pension burden is a cause for great concern as benefits have been maintained and as the number of recipients has risen, owing (in part) to people leaving the labour-force.

pened elsewhere, so that active policies were affordable.

IV. CONCLUSIONS

This Assessment has touched on some of the issues concerned with transition: many others are raised in the articles in this *Review*. The wide diversity of experience perhaps makes it inevitable that there are more questions than answers: and that any lessons remain tentative.

We started, in the Introduction, with the question of whether the large output declines experienced initially in all the transition economies of the former Soviet Union and in the former centrally planned countries of central Europe were inevitable. The contrast with China and Vietnam, which fit much better with the theoretical idea that transition should improve output and potential welfare, has been noted more than once.

There is still no easy answer as to why Asian experience has been so different—and if there is an answer it may lie in the political rather than the economic sphere. One suggestion, often put forward (e.g. World Bank, 1996) is that the situations were not comparable because China and Vietnam at the start of their reform programmes were largely agrarian, with huge untapped reserves of labour. Thus structural adaptation—the growth of some sectors and activities with the decline or elimination of others—was not required in the same way as in the industrialized Soviet Union or in eastern Europe. There is obviously something in this, but it simply begs the question of whether more gradualist strategies were possible and, if not, why not. The key feature of the 'Asian' transitions has been, as noted in section II, the growth of the new 'private' sector. Why, in other countries, could not the old system continue while the new system grew to supplant it, causing, no doubt, painful structural adjustment but only as reforms succeeded?

The wider political context appears crucial. In China, the transition strategy was adopted to avoid economic collapse and to avoid political disintegration. In the Soviet Union the situation was almost reversed, with political disintegration leading to economic collapse and requiring a complete change in the political and economic system. In the former satellites, there was the additional feature of getting rid of a former occupying power that was ceasing to be powerful.

One aspect of political and economic breakdown was the collapse of the CMEA, which clearly constitutes part of the explanation for the generalized output fall in transition economies. Its effects were particularly large in the former Soviet Union.

As argued above, however, structural change effects, whether due to the trade shock or to relative price changes at the beginning of transition—owing to subsidy removal, for example—do not appear to be the whole story. The response of enterprises to 'big-bang'-type price and trade liberalization, combined with interest-rate rises and monetary restraint, appears to have played a major part. This should not, at least with hindsight, be surprising. A policy of more-or-less complete liberalization, in a situation where competitive forces were initially very weak and where the banking system was, to put it mildly, imperfect, is likely to lead to perverse responses. We have suggested that, for Poland, but also more generally, the defensive, price-raising behaviour of the state-enterprise sector constituted an additional and major 'supply shock', comparable to a large indirect tax rise. The shock was price-raising and output-lowering and helps to explain the suddenness of the output decline at the start of transition in the central and eastern European countries and in the former Soviet Union. It also helps to explain inflation, which took on a cumulative character in countries which failed to maintain budgetary restraint.

Was the policy of liberalization, combined with hardening of budget constraints and interest-rate rises, then a mistake? It is not a question that can easily be answered. Politically there may well have been no alternative. But it would seem that claims that liberalization is part of macroeconomic stabilization should be treated with scepticism. On the contrary, the rise in prices surely destabilized inflation expectations initially and the output fall made fiscal control quite extraordinarily difficult and, in most cases, socially very costly.

Most of the articles in this issue of the *Review* are not about the initial stage of transition but about progress since—with a focus on the more successful reformers (especially the Czech Republic, Hungary, Poland, and Slovakia). There is growing evidence that success correlates with progress in reform. There is also little disagreement that success requires stabilization in the conventional sense of curbing inflation and maintaining it at moderate (though, in some cases, still relatively high) levels. In turn, this requires fiscal and monetary discipline. It is also notable that the more successful reformers have been extremely successful in reorienting their trade towards western markets, especially to the European Union. Indeed, it is questionable whether, for these countries, the term 'transition economy' is meaningful any more.

The role of policy and the instruments available clearly change in the course of transition. One particularly obvious dilemma concerns the role of the exchange rate. In terms of supply-side responses, a combination of openness and a low (or undervalued) exchange rate maximizes the potential for profitable exports, an important part of the overall strategy for recovery and structural change. But openness is also vitally important in introducing competition to the domestic market and forcing needed structural change, which points to a hard exchange-rate policy. The issue is further complicated by the possible macroeconomic role of the exchange rate as a nominal anchor in curbing inflation and inflation expectations.

As noted, most of the countries opted for undervaluation initially, despite the inflationary risks and despite the cost to competition in the domestic market. There is still clearly a concern to maintain competitiveness as an aid to rapid outward-oriented growth. This strategy is increasingly threatened, most obviously by capital inflows.

The wider difficulty is this. As reform progresses, and as financial markets develop, monetary policy becomes increasingly a matter of controlling the short-term interest rate. The instrument can be targeted towards the exchange rate, or towards the domestic economy (e.g. towards a domestic monetary aggregate or, more generally, towards the management of consumption and investment demand). Liberalization and openness mean that serious conflicts between objectives are bound to emerge. Moreover, experience suggests that capital flows can also be highly destabilizing—especially if domestic policy appears inconsistent or faulty. The benefits of openness come at a cost.

But this also has implications for other aspects of domestic policy. In the first place, it suggests a more active role for fiscal policy, not only in helping to offset shocks, but also, in the medium term, in balancing savings and investment. The latter role may well require budget surpluses (increasing the overall savings rate for the economy) to avoid excess demand, or an excessive reliance on capital inflows and net imports. Second, however, it points to the continuing importance of reforms and improvements in corporate governance, in the banking system, and in other financial institutions. Some of the main risks still come from excessive borrowing or lending (increasingly easy in integrated markets) and a fragile, under-regulated, banking system.

But what of the future? The most successful reformers are members of the OECD (the Czech Republic, Hungary and Poland) and, along with Slovenia and Estonia, are likely to be in the first wave to be considered for full membership of the EU. As shown in Table 1, incomes *per capita* are still low. Clearly, there is an objective of rapid growth and catch-up. Indeed, given relatively high levels of human capital, geographical proximity to European markets, and cultural factors, the idea of catch-up is about to be put to the test.

One way of looking at the prospects is to see these countries as constituting a low-wage region on the edge of the present EU. Despite rapid wage rises since the start of reforms, and worries over competitiveness, wages are still very low compared with core European countries (about \$300–350 per month). This constitutes their main locational advantage. But it is only an advantage if education, skills, and social infrastructure are also present, and then only if the macroeconomic environment is stable.

There are other points that need to be made. The first is about incentives and corporate governance. Viewed as a region wanting to catch up, the incentive structure needs to support radical change towards the best international practice. So far, different forms of privatization and governance have not really been tested. Much of the restructuring and export reorientation has been defensive. Increasingly, however, if the countries are to catch up, the incentives will matter. The second is about investment. Rapid catch-up, if it is to occur, will require high levels of investment. On the one hand, this points to the need to increase savings within the area—they are currently much lower than found, for example, among the rapidly growing Asian countries. It also points to the possibility of importing investment goods financed by borrowing on the international capital market. The risks indicate again the need for strong banking systems and structures of corporate governance. An alternative is foreign direct investment. A third point is the need to maintain and improve human capital and social infrastructure which should also be seen as investment.

Clearly, catch-up is by no means automatic and there are lots of examples of low-wage regions that fail to converge. One of the main risks—at the heart of the dilemmas that face policy-makers in the successful reforming countries—is that the regional advantage will be lost, owing to a rising real exchange rate, before the convergence process gets under way.

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